

# Notice to Members

SEPTEMBER 2005

## SUGGESTED ROUTING

Internal Audit  
Legal and Compliance  
Retail  
Senior Management

## KEY TOPICS

Derivatives  
Options  
Structured Products  
Structured Securities

## GUIDANCE

### Structured Products

#### NASD Provides Guidance Concerning the Sale of Structured Products

#### Executive Summary

As a result of a recent review of members that sell structured products, NASD staff is concerned that members may not be fulfilling their sales practice obligations when selling these instruments, especially to retail customers. This *Notice to Members* provides guidance to members concerning their obligations when selling structured products, including the requirements to: (1) provide balanced disclosure in promotional efforts; (2) ascertain accounts eligible to purchase structured products; (3) deal fairly with customers with regard to derivative products; (4) perform a reasonable-basis suitability determination; (5) perform a customer-specific suitability determination; (6) supervise and maintain a supervisory control system; and (7) train associated persons.

#### Questions/Further Information

Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8104.

#### Background

Structured products are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency.<sup>1</sup> As the foregoing definition suggests, there are myriad types of structured products. Some structured products offer full protection of the principal invested, whereas others offer limited or no protection of the principal.

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Most structured products pay an interest or coupon rate substantially above the prevailing market rate.<sup>2</sup> Structured products also frequently cap or limit the upside participation in the reference asset, particularly if some principal protection is offered or if the security pays an above-market rate of interest.

Structured products, which are typically issued by investment banks or their affiliates, have a fixed maturity. Some, but not all, structured products may be listed on a national securities exchange. Moreover, even those structured products listed on a national securities exchange may be very thinly traded.

Structured products typically have two components—a note and a derivative (often an option). The note pays interest to the investor at a specified rate and interval. The derivative component establishes the payment at maturity. In some products, the derivative is, in effect, a put option sold by the investor that gives the issuer the right, but not the obligation, to sell the investor the reference security or securities at a predetermined price. In other products, the derivative is, in effect, a call option sold by the investor that gives the issuer the right, but not the obligation, to buy from the investor the reference security or securities at a predetermined price. Despite the derivative component of a structured product, they are often marketed to investors as debt securities.

Sales of structured products began in the 1980s. The products gained popularity with institutional investors in the 1990s. More recently, members have reported to NASD that structured products have been increasingly targeted at retail investors. Many of the structured products targeted at retail investors are based upon “blue-chip” and “household-name” stocks that comprise the S&P 500 or the NASDAQ-100 indexes. NASD staff has concerns about the manner in which structured products may be marketed to retail investors and the types of investors purchasing such products. As such, NASD is issuing this guidance to members addressing sales practice issues.

## Regulatory Requirements

The application of NASD rules to activities involving structured products, including Rules 2110 (Standards of Commercial Honor and Principles of Trade), 2210 (Communications with the Public), 2310 (Recommendations to Customers), 2720 (Distribution of Securities of Members and Affiliates—Conflicts of Interest), 3010 (Supervision), and 3012 (Supervisory Control Systems), is discussed below.

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## 1. Promotion of Structured Products

Offerings of structured products generally are conducted as public offerings of securities registered under the Securities Act of 1933. In most cases, structured products are offered from a shelf registration. An investor purchasing a structured product as part of a shelf distribution will, prior to purchase, receive a preliminary prospectus supplement that describes the characteristics and risks of the structured product being offered. To varying degrees, members also use supplemental sales materials. NASD staff has observed that the disclosures provided in supplemental sales materials tend to be less balanced and offer fewer risk disclosures than are contained in the preliminary and final prospectus supplements.

NASD reminds members that pursuant to Rule 2210, all sales materials and oral presentations regarding structured products must present a fair and balanced picture regarding both the risks and benefits. For example, marketing materials should not portray structured products as “conservative” or a source of “predictable current income” unless such statements are accurate, fair, and balanced. In addition, Rule 2210 prohibits exaggerated statements and the omission of any material fact or qualification that would cause a communication to be misleading. Moreover, in promoting the advantages of structured products, such as the interest rate offered and the creditworthiness of the issuer, it is necessary that members balance their promotional materials with disclosures concerning the attendant risks, which may include loss of principal and the possibility that at expiration the investor will own the reference asset at a depressed price. In general, NASD staff believes that sales materials and oral presentations that omit a description of the derivative component of the product and instead present such products as ordinary debt securities would violate Rule 2210. In addition, members should be careful to balance any statements concerning the fact that a structured product has a ticker symbol or has been approved for listing on an exchange with the risks that an active and liquid trading market may not develop. Members are further reminded that providing risk disclosure in a prospectus supplement does not cure otherwise deficient disclosure in sales material, even if such sales material is accompanied or preceded by the prospectus supplement.<sup>3</sup>

In some cases, structured products are assigned a credit rating by a nationally recognized statistical rating organization. To the extent that such credit rating pertains to the creditworthiness of the issuer (*i.e.*, the ability of the issuer to meet its obligations under the terms of the structured product) and is not indicative of the market risk associated with the structured product or the reference security, members must be careful to delineate these distinctions. Presentation of a credit rating for a structured product that suggests that the rating pertains to the safety of the principal invested or the likely investment returns will be viewed as misleading. Members presenting a credit rating must address the fact that the creditworthiness of the issuer does not affect or enhance the likely performance of the investment other than the ability of the issuer to meet its obligations.

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## 2. Eligible Accounts

### A. Approved Accounts

Member firms also should consider whether purchases of some or all structured products should be limited to investors that have accounts that have been approved for options trading. Given the similar risk profile of many structured products and options, particularly those where principal invested is at risk from market movements in the reference security, it may be an appropriate investor safeguard to require that such structured products only be purchased in accounts approved for options trading. Firms that determine not to limit purchases of structured products in which investors' principal is at risk from market movements in the reference security to accounts approved for options trading should develop other comparable procedures designed to ensure that structured products are only sold to persons for whom the risk of such products is appropriate. These firms should be prepared to demonstrate the basis for allowing investors with accounts not approved for trading options to purchase structured products.

Members also are reminded that approving an account to trade structured products is not a substitute for a thorough suitability analysis. Not every structured product will be suitable for every account approved to trade structured products. A discussion of suitability is provided below.

### B. Discretionary Accounts

Sales of structured products issued by a member, or an affiliate of a member, to discretionary accounts must comply with Rule 2720 (Distribution of Securities of Members and Affiliates—Conflicts of Interest). Specifically, paragraph (l) (Discretionary Accounts) provides that "a transaction in securities issued by a member or an affiliate of a member, or by a company with which a member has a conflict of interest shall not be executed by any member in a discretionary account without prior specific written approval of the customer." Members should review their written supervisory procedures and practices to ensure that they request and obtain the necessary written approval of the customer before purchasing structured products in a discretionary account.

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### 3. Suitability and Fair Dealing with Customers

#### A. Fair Dealing with Customers with Regard to Derivative Products or New Financial Products

IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products) emphasizes members' obligations to deal fairly with customers when making recommendations or accepting orders for new financial products. The IM states that "[a]s new products are introduced from time to time, it is important that members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding the products."

For certain enumerated products, including a type of structured product listed on NASDAQ known as "Selected Equity-Linked Debt Securities" (SEEDS), IM-2310-2(e) provides specific guidelines that members must follow for "qualifying accounts to trade the products and for supervising the accounts." In this regard, Rule 4420(g)(5) requires prior to the commencement of trading of particular SEEDS, delivery to a broker-dealer of a circular providing guidance regarding its compliance responsibilities (including suitability recommendations and account approval) when handling transactions in SEEDS.<sup>4</sup> Similar disclosure requirements exist with respect to the listing standards of structured products on national securities exchanges.<sup>5</sup>

#### B. Reasonable Basis Suitability

As noted in *Notices to Members (NTMs) 03-07* and *03-71*, a member has an obligation to perform a reasonable basis suitability determination before recommending a product to investors. A reasonable basis suitability determination is necessary to ensure that a security—in this case a structured product—is suitable for some investors (as opposed to the customer-specific suitability determination, which is made on an investor-by-investor basis). To discharge its reasonable basis suitability obligation, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards. Members also are reminded of the guidance issued in *NTM 05-26*, which provides best practices for developing and vetting new products, including structured products.

Members should consider whether an investment in a structured product meets the reasonable basis suitability standard if the instrument is priced such that the potential yield is not an appropriate rate of return in relation to the volatility of the reference asset based upon comparable or similar investments, in terms of structure, volatility, and risk in the market as determined at the time the structured product is issued. For example, similar structured products based on reference securities that possess substantially similar volatility characteristics, but which offer materially different rates of return in the note component, should call into question whether the instrument with the lower yield meets the reasonable basis suitability standard. While an exact risk/reward calibration among different instruments or investments may not be

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possible, NASD expects members to exercise their market expertise to recognize those situations where the materiality of difference is not in doubt and, consequently, identify that the lower yielding instrument does not represent a reasonable rate of return given the attendant risks as compared to other similarly composed products or direct investments in the underlying components of such products with similar risk/reward attributes.

### C. Customer Specific Suitability

A member also must determine that its recommendation to purchase a structured product is suitable for that particular investor. Under Rule 2310, members must ensure that a recommendation is suitable for a specific customer by examining (1) the customer's financial status, (2) the customer's tax status, (3) the customer's investment objectives, and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

The derivative component of structured products and the potential loss of the principal for many such products may make them unsuitable for investors seeking alternatives to debt securities. While structured products pay interest like debt securities, they often exhibit very different profit and loss potential. The profit and loss potential of many structured products is more akin to an option contract, particularly those where principal invested is at risk from market movements in the reference security. For such products, it may be useful for registered representatives to consider whether the customer meets the suitability requirements for options trading.<sup>6</sup> In particular, Rule 2860(b)(19)(B) requires that "no member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract" (emphases added).

Members also should not make any generalized conclusions about the "relative" suitability of a structured product and an investment in the reference asset. NASD does not believe that members should assume that if an investment in the reference asset is suitable, then an investment in a structured product pertaining to such reference asset also must be suitable. Conversely, members should not assume that if an investment in the structured product is suitable, then so too is an investment in the reference asset. As discussed above, structured products may have very different risk-reward profiles than their reference assets. Suitability must be determined on an investor-by-investor basis, with reference to the specific facts and circumstances of each investor.

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Moreover, where an instrument is structured such that there is a risk of losing all or a substantial portion of the principal in return for above-market rate current income, the volatility of the reference asset upon which total return of the investment depends will be an important factor in determining whether it is suitable for a customer. For example, structured product ABC with a highly volatile reference asset may pay an interest rate of 40 percent to account for the risk, whereas structured product XYZ with a less volatile reference asset may only pay an interest rate of 20 percent. Despite the higher interest rate of structured product ABC, the risk of principal owing to the increased volatility of the reference asset may make structured product ABC less suitable for an investor than structured product XYZ notwithstanding its lower interest rate.

#### **4. Supervision and Supervisory Control System**

Under Rule 3010, members must establish written supervisory procedures that are reasonably designed to ensure that sales of structured products comply with all applicable securities laws, and SEC and NASD rules. Members must ensure that their written procedures for supervisory and compliance personnel include that (1) reasonable-basis suitability is completed before products are offered for sale; (2) associated persons perform appropriate customer-specific suitability analysis; (3) the firm has procedures to determine accounts eligible to purchase structured products; and (4) all promotional materials are accurate and balanced. In addition, members are reminded that their written supervisory control system required under Rule 3012 requires members to test and verify that their written supervisory procedures are reasonably designed to ensure adequate compliance with all applicable securities laws, and SEC and NASD rules.

Firms also should consider the best practices for vetting new products discussed in *NTM 05-26*. These best practices include having compliance and legal personnel involved in the initial product assessment and having supervisory personnel participate in the product review process.

#### **5. Training**

Members must train registered personnel about the characteristics, risks, and rewards of each structured product before they allow registered persons to sell that product to investors. In connection with such training, members should train registered persons about the factors that would make such products either suitable or unsuitable for certain investors. Members' focus on training should not be limited to representatives selling structured products; members also should provide appropriate training to supervisors of registered persons selling structured products.

Training for all persons should emphasize that, due to the unique nature of these products, many investors, especially retail investors, may not understand the features of the product, and may not fully appreciate the associated risks of investing in them. Moreover, in light of the fact that investors may be turning to these products as an alternative to traditional equity and fixed income investments, it is crucial for registered persons to have a full and balanced understanding regarding both the risks and the rewards of these products.

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## Endnotes

- 1 There is no standardized definition of a structured product in the federal securities laws. SEC Rule 434 (Prospectus Delivery Requirements in Firm Commitment Underwritten Offerings of Securities for Cash) defines structured securities as “securities whose cash flow characteristics depend upon one or more indices or that have embedded forwards or options or securities where an investor’s investment return and the issuer’s payment obligations are contingent on, or highly sensitive to, changes in the value of underlying assets, indices, interest rates or cash flows.” The Pacific Exchange defines structured products as “products that are derived from and/or based on a single security or securities, a basket of stocks, an index, a commodity, debt issuance and/or a foreign currency, among other things” and would include “index and equity linked notes, term notes and units generally consisting of a contract to purchase equity and/or debt securities at a specified time.” Securities Exchange Act Rel. No. 51094 (Jan. 28, 2005), 70 FR 6489 (Feb. 7, 2005) (Order Approving Proposed Rule Change and Amendment No. 1 and 2 Thereto by the Pacific Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Thereto Relating to a Proposed Listing Fee Schedule for Structured Products). The NYSE defines a structured product as “a security, which is based on the value of another security.” Securities Exchange Act Rel. No. 42746 (May 2, 2000), 65 FR 30171 n.7 (May 10, 2000) (Order Granting Approval to Proposed Rule Change and Amendment No. 1 Thereto Relating to the NYSE’s Allocation Policy and Procedures).
  - 2 NASD staff has observed structured products paying interest rates as high as 40 percent per year.
  - 3 See, e.g., *Department of Enforcement v. Hornblower & Weeks*, 2004 NASD Discip. LEXIS 27 (respondent could not cure defects in disclosure by providing more detail and further disclosure in the same package or by answering questions); *DOE v. Ryan Mark Reynolds*, 2001 NASD Discip LEXIS 17 (“The SEC has held that, in the enforcement context, a registered representative may be found in violation of the NASD’s rules and the federal securities laws for failure to fully disclose risks to customers even though such risks may have been discussed in a prospectus delivered to customers.”); *Department of Enforcement v. Pacific On-Line Trading & Securities*, 2002 NASD Discip. LEXIS 19 (finding that the subsequent dissemination of disclosure information does not cure earlier misleading disclosures).
- Members also should consider whether their disclosures concerning structured products provide a basis for liability under sections 12(a)(2) and 17(a) of the Securities Act of 1933 (Securities Act) or section 10(b)(5) of the Securities Exchange Act of 1934 (Exchange Act). See *In the Matter of Robert A. Foster*, 51 SEC 1211 (1994) (notwithstanding distribution of the prospectuses, party is liable under Section 10(b)(5) of the Exchange Act and Section 17(a) of the Securities Act for making untrue statements of material facts and omitting to state material facts necessary in order to make the statements made not misleading).



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- 4 A nearly identical requirement also exists with respect to listings of “Other Securities” pursuant to Rule 4420(f). See Rule 4420(f)(3).
  - 5 See, e.g., AMEX Rule 107A, PHLX Rule 803(f), NSX Section 1.3, CHX Rule 13.
  - 6 For structured products that are listed on an exchange (or traded on NASDAQ), the applicable listing standards typically require the exchange (or NASDAQ) to issue an information circular regarding compliance responsibilities, including suitability and account approval). See *supra* note 5. Member firms should review these information circulars to ensure that they adhere to the appropriate standards.

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